

FINANCIAL AUDIT
INCLUDING THE PROVISIONS OF THE SINGLE AUDIT ACT
OF THE

MICHIGAN STRATEGIC FUND
(A Component Unit of the State of Michigan)

October 1, 2000 through September 30, 2002



Michigan *Office of the Auditor General* **REPORT SUMMARY**

Financial Audit

*Including the Provisions of the Single Audit Act
October 1, 2000 through September 30, 2002*

Michigan Strategic Fund

Report Number:
07-400-03

Released:
June 2003

A Single Audit is designed to meet the needs of all financial report users, including an entity's federal grantor agencies. The audit determines if the financial schedules and/or financial statements are fairly presented; considers internal control over financial reporting and internal control over federal program compliance; determines compliance with State compliance requirements material to the financial schedules and/or financial statements; and assesses compliance with direct and material requirements of the major federal programs.

Financial Statements:

Auditor's Report Issued

We issued an unqualified opinion on the Michigan Strategic Fund's (MSF's) financial statements.

~ ~ ~ ~ ~

Internal Control Over Financial Reporting

We did not identify any material weaknesses in internal control over financial reporting.

~ ~ ~ ~ ~

Noncompliance Material to the Financial Statements

We did not identify any instances of noncompliance applicable to the financial statements that are required to be reported under *Government Auditing Standards*.

~ ~ ~ ~ ~

Federal Awards:

Auditor's Report Issued on Compliance

We audited one program as a major program and issued an unqualified opinion. The federal program audited as a major program is identified on the back of this summary.

~ ~ ~ ~ ~

Internal Control Over Major Program

We did not identify any material weaknesses in internal control over the major program.

~ ~ ~ ~ ~

Required Reporting of Noncompliance

We identified an instance of noncompliance that is required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133 (Finding 1).

~ ~ ~ ~ ~

We audited the following program as a major program:

<u>CFDA Number</u>	<u>Program Title</u>	<u>Compliance Opinion</u>
14.228	Community Development Block Grants/State's Program	Unqualified

A copy of the full report can be
obtained by calling 517.334.8050
or by visiting our Web site at:
www.state.mi.us/audgen/



Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

Thomas H. McTavish, C.P.A.
Auditor General

James S. Neubecker, C.P.A., C.I.A., D.P.A.
Executive Deputy Auditor General

Scott M. Strong, C.P.A., C.I.A.
Director of Audit Operations



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

June 27, 2003

Ms. Sabrina Keeley
Michigan Strategic Fund
300 North Washington Square
Lansing, Michigan

Dear Ms. Keeley:

This is our report on the financial audits of the Michigan Strategic Fund for the fiscal years ended September 30, 2002 through September 30, 2001 and the audit of the provisions of the Single Audit Act for the Michigan Strategic Fund (MSF) for the period October 1, 2000 through September 30, 2002.

This report contains our report summary; our independent auditor's report on the financial statements; the MSF management's discussion and analysis; and the MSF financial statements, notes to financial statements, and schedule of expenditures of federal awards. This report also contains our independent auditor's reports on compliance and on internal control over financial reporting and on compliance with requirements applicable to each major program and on internal control over compliance in accordance with U.S. Office of Management and Budget Circular A-133 and our schedule of findings and questioned costs. In addition, this report contains MSF's summary schedule of prior audit findings, its corrective action plan, and a glossary of acronyms and terms.

Our finding and recommendation are contained in Section III of the schedule of findings and questioned costs. The entity preliminary response is contained in the corrective action plan. The *Michigan Compiled Laws* and administrative procedures require that the audited entity develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

A handwritten signature in black ink, reading "Thomas H. McTavish".

Thomas H. McTavish, C.P.A.
Auditor General

This page left intentionally blank.

TABLE OF CONTENTS

MICHIGAN STRATEGIC FUND

	<u>Page</u>
INTRODUCTION	
Report Summary	1
Report Letter	3
INDEPENDENT AUDITOR'S REPORT AND FINANCIAL STATEMENTS	
Independent Auditor's Report on the Financial Statements	7
Management's Discussion and Analysis	9
Michigan Strategic Fund Financial Statements	
Statement of Net Assets and Fund Balance Sheet	13
Statement of Activities and Fund Statement of Revenues, Expenditures, and Changes in Fund Balance	14
Notes to the Financial Statements	15
SUPPLEMENTAL FINANCIAL SCHEDULE	
Schedule of Expenditures of Federal Awards	24
INDEPENDENT AUDITOR'S REPORTS ON COMPLIANCE AND INTERNAL CONTROL	
Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting	26

Independent Auditor's Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133	28
-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	----

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Section I: Summary of Auditor's Results	31
Section II: Findings Related to the Financial Statements	32
Section III: Findings and Questioned Costs Related to Federal Awards	33
1. Payroll Distributions	33

OTHER SCHEDULES

Summary Schedule of Prior Audit Findings	36
Corrective Action Plan	38

GLOSSARY

Glossary of Acronyms and Terms	39
--------------------------------	----



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on the Financial Statements

December 27, 2002

Mr. Doug Rothwell, President
Michigan Strategic Fund
300 North Washington Square
Lansing, Michigan

Dear Mr. Rothwell:

We have audited the financial statements of the Michigan Strategic Fund, a component unit of the State of Michigan, as of and for the fiscal years ended September 30, 2002 and September 30, 2001, as identified in the table of contents. These financial statements are the responsibility of the Michigan Strategic Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1b, the financial statements present only the Michigan Strategic Fund and do not purport to, and do not, present fairly the financial position of the State of Michigan or its component units as of September 30, 2002 and September 30, 2001 and the changes in financial position thereof for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Michigan Strategic Fund as of

September 30, 2002 and September 30, 2001 and the changes in financial position for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.


As discussed in Notes 1c and 6 the Michigan Strategic Fund adopted Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*; Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*; and Statement No. 38, *Certain Financial Statement Note Disclosures*.

The management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated December 27, 2002 on our tests of the Michigan Strategic Fund's compliance with certain provisions of laws, regulations, contracts, and grants and on our consideration of its internal control over financial reporting. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the Michigan Strategic Fund's financial statements referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Sincerely,

A handwritten signature in black ink, reading "Thomas H. McTavish". The signature is fluid and cursive, with a long horizontal line extending from the left side of the name.

Thomas H. McTavish, C.P.A.
Auditor General

Management's Discussion and Analysis

This is a discussion and analysis of the financial performance of the Michigan Strategic Fund (MSF) for the fiscal year ended September 30, 2002. Act 270, P.A. 1984, created MSF. Executive Order No. 1999-1, effective April 5, 1999, transferred MSF to the Department of Management and Budget as an autonomous agency, governed by a nine-member board of directors. MSF is a component unit of the financial reporting entity of the State of Michigan. MSF's management is responsible for the financial statements, notes to the financial statements, and this discussion.

Using the Financial Report

This financial report is prepared in accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*.

- The reporting standards require a statement of net assets; a fund balance sheet; a statement of activities; and a statement of revenues, expenditures, and changes in fund balance.
- The reporting standards also require that special purpose governments provide both fund financial statements and government-wide financial statements. GASB Statement No. 34 also provides for combining these statements using a format that reconciles the two statements. Because this entity does not have any reconciling items, the statements are presented using one column for both presentations.

This financial report includes the reports of independent auditors, management's discussion and analysis, the basic financial statements, and the notes to the financial statements.

The financial statements are interrelated and represent the financial status of MSF. As previously noted, the balance sheet is now referred to as the statement of net assets and fund balance sheet, which includes assets and liabilities.

The statement of revenues, expenditures, and changes in fund balance is combined with the statement of activities to present the revenues earned and expenditures incurred during the year.

Analysis of Financial Activities

The primary source of revenue for MSF is legislative appropriations from the State of Michigan. MSF also collects an 8% share of the net revenues from several casinos operated by Native American tribes.

Except for the administrative cost of classified employees detailed to the Michigan Economic Development Corporation (MEDC) and federal Community Development Block Grants (CDBG) funding, all funds received by MSF from the State of Michigan are used at the discretion of the MEDC Executive Committee within the legislative intent of the appropriations act.

Condensed Financial Information

From the Statement of Net Assets and Fund Balance Sheet

As of September 30

	2002	2001
Amounts due from federal government	\$ 7,608,360	\$ 7,299,243
Other current assets	4,748,978	5,507,957
Total Assets	<u>\$ 12,357,339</u>	<u>\$ 12,807,200</u>
Amount due to MEDC (gaming revenues, etc.)	\$ 4,600,000	\$ 5,298,031
Other current liabilities	7,633,470	7,333,003
Total Liabilities	<u>\$ 12,233,470</u>	<u>\$ 12,631,034</u>
Total Fund Balance/Net Assets	<u>123,869</u>	<u>176,166</u>
Total Liabilities and Fund Balance/Net Assets	<u>\$ 12,357,339</u>	<u>\$ 12,807,200</u>

Amounts due from federal government primarily consist of receivables for federal pass-through funds for the CDBG Program and corresponds to **other current liabilities**, which primarily include amounts payable to the subgrantees from these federal pass-through funds.

Other current assets primarily include gaming revenues receivable for six months (April 1, 2002 through September 30, 2002). The amount reported was estimated based on the average of three prior reporting periods.

Amount due to MEDC reflects revenues collected after the end of the fiscal year and transferred to MEDC in the following months in accordance with the terms of the interlocal agreement.

Total Fund Balance/Net Assets reflect primarily cash on hand at the end of the fiscal year.

Condensed Financial Information From the Statement of Activities and Fund Statement of Revenues, Expenditures, and Changes in Fund Balance
For the Fiscal Years Ended September 30

	2002	2001
Revenues		
Charges for services	\$ 1,122,974	\$ 1,613,066
Operating grants and contributions	35,860,762	41,194,671
Payments from State of Michigan	107,940,683	115,316,338
Other	10,195,201	13,495,327
Total Revenues	<u>\$ 155,119,620</u>	<u>\$ 171,619,402</u>
Expenditures		
CDBG	\$ 35,645,228	\$ 40,663,095
Payments to MEDC	115,691,890	126,880,019
Other	3,834,799	3,979,354
Total Expenditures	<u>\$ 155,171,918</u>	<u>\$ 171,522,468</u>
Excess of Revenues Over Expenditures/		
Change in Net Assets	\$ (52,297)	\$ 96,934
Fund Balance/Net Assets - Beginning	176,166	79,232
Fund Balance/Net Assets - Ending	<u>\$ 123,869</u>	<u>\$ 176,166</u>

Charges for services primarily consist of industrial development revenue bond (IDRB) fees and application fees for Brownfield and the Michigan Economic Growth Authority

(MEGA). The decrease in charges for services revenue during fiscal year 2001-02 reflects decreased activities for IDRb.

Operating grants and contributions declined primarily because of a reduction of CDBG federal pass-through grant expenditures and corresponding federal revenue by the subgrantees.

Payments from the State of Michigan primarily consist of the State's General Fund and Tobacco Settlement Trust Fund appropriations for MSF. Payments from the State of Michigan declined in fiscal year 2001-02 primarily because of a reduction in the State appropriation from the Tobacco Settlement Trust Fund for the Life Science Program (\$5.0 million) and the General Fund for the Economic Development Job Training Program (\$3.8 million). This also accounts for reduced payments to MEDC in fiscal year 2001-02 when compared with fiscal year 2000-01.

Other Pertinent Information

The opening of two more casinos covered by a 1998 compact is expected in fiscal years 2002-03 and 2003-04 and may increase gaming revenues. The opening date of these casinos and the estimated revenues are not certain.

During fiscal year 1996-97 through fiscal year 2001-02, MSF disbursed \$31.9 million CDBG federal funds for Industrial Park Loans/Grants to various local government entities. Per the agreement, local entities either could receive credits for creating a specific number of jobs or would need to return the funds to MSF. As of September 30, 2002, local entities received \$8.7 million in job credits and repaid \$3.3 million. In the event that no further jobs are created by these local entities, MSF may receive up to \$19.9 million in future years. These returned funds are treated as recaptured funds and, per federal regulation, are reused for other CDBG purposes.

MICHIGAN STRATEGIC FUND
Statement of Net Assets and Fund Balance Sheet
As of September 30

	<u>2002</u>	<u>2001</u>
ASSETS		
Current Assets:		
Cash (Note 2)	\$ 87,087	\$ 60,250
Equity in Common Cash		133,844
Amounts due from federal government	7,608,360	7,299,243
Amounts due from local units		2,000
Other current assets (Note 3)	4,661,891	5,311,863
Total Current Assets	<u>\$ 12,357,339</u>	<u>\$ 12,807,200</u>
 Total Assets	 <u><u>\$ 12,357,339</u></u>	 <u><u>\$ 12,807,200</u></u>
 LIABILITIES		
Current Liabilities:		
Accounts payable and other liabilities	\$ 7,554,532	\$ 7,329,427
Amounts due to component units	4,600,000	5,298,031
Amounts due to primary government	10,502	3,576
Deferred revenue	68,436	
Total Current Liabilities	<u>\$ 12,233,470</u>	<u>\$ 12,631,034</u>
Total Liabilities	<u>\$ 12,233,470</u>	<u>\$ 12,631,034</u>
 FUND BALANCE/NET ASSETS		
Unreserved fund balance/Unrestricted net assets	<u>\$ 123,869</u>	<u>\$ 176,166</u>
Total Fund Balance/Net Assets	<u>\$ 123,869</u>	<u>\$ 176,166</u>
 Total Liabilities and Fund Balance/Net Assets	 <u><u>\$ 12,357,339</u></u>	 <u><u>\$ 12,807,200</u></u>

The accompanying notes are an integral part of the financial statements.

MICHIGAN STRATEGIC FUND
Statement of Activities and Fund Statement of Revenues,
Expenditures, and Changes in Fund Balance
For the Fiscal Year Ended September 30

	<u>2002</u>	<u>2001</u>
REVENUES (Note 1d)		
<u>Charges for Services</u>		
IDRB Program fees	\$ 370,637	\$ 840,450
Other fees	752,337	772,616
<u>Operating Grants and Contributions</u>		
Community Development Block Grant (federal) (Note 6)	33,147,308	38,169,807
Community Development Block Grant (local and others) (Note 6)	1,948,935	2,254,864
Employment Services (federal)	764,519	770,000
<u>Miscellaneous Revenues</u>		
Payment from MEDC	2,937,913	
Payments from General Fund	60,002,770	65,316,338
Payments from Tobacco Settlement Trust Fund	45,000,000	50,000,000
Loan and other interest		525,675
Tribal gaming (Note 6)	10,004,898	9,294,225
Miscellaneous	190,303	3,675,426
Total Revenues	<u>\$ 155,119,620</u>	<u>\$ 171,619,402</u>
EXPENDITURES (Note 1d)		
Administrative	\$ 651,073	\$ 203,521
Bad debts		3,588,638
Community Development Block Grant (Note 6)	35,645,228	40,663,095
Payments to MEDC	115,691,890	126,880,019
Payments to General Fund (indirect and refund)	3,183,726	187,196
Total Expenditures	<u>\$ 155,171,918</u>	<u>\$ 171,522,468</u>
Excess of Revenues Over Expenditures/Change in Net Assets	\$ (52,297)	\$ 96,934
Fund Balance/Net Assets - Beginning	<u>176,166</u>	<u>79,232</u>
Fund Balance/Net Assets - Ending	<u>\$ 123,869</u>	<u>\$ 176,166</u>

The accompanying notes are an integral part of the financial statements.

Notes to the Financial Statements

Note 1 Significant Accounting Policies

The accounting policies of the Michigan Strategic Fund (MSF) conform to accounting principles generally accepted in the United States of America as applicable to governmental units. The following is a summary of the more significant policies:

a. Reporting Entity

MSF was created by Act 270, P.A. 1984, to help diversify the economy of the State and to provide for economic development, primarily by assisting business enterprises in obtaining additional sources of financing. Under the provisions of this Act, MSF succeeded to the rights, properties, obligations, and duties of the Michigan Job Development Authority and the Michigan Economic Development Authority.

MSF is governed by a nine-member board of directors that consists of the director of the Department of Management and Budget, the State Treasurer, and seven members appointed by the Governor with the advice and consent of the Senate.

Executive Order No. 1999-1, effective April 5, 1999, transferred MSF to the Department of Management and Budget as an autonomous agency. The Order also transferred the following programs and functions of the Michigan Jobs Commission to MSF:

- Capital Resources Group
- Commercial Redevelopment Act
- Community Development Block Grants (CDBG)
- Department of Economic Expansion and Economic Expansion Council
- Economic Development Corporations Act
- Economic Development Job Training
- K.I. Sawyer Conversion Authority
- Michigan Business Incubation Act
- Michigan Economic Growth Authority
- Michigan Enterprise Zone Authority

Michigan International Trade Authority
Michigan Renaissance Zone Act
Michigan Training Incentive Fund
Michigan Travel Commission
Michigan Urban Land Assembly Act
Minority, Women, and Small Business Services Units
Neighborhood Enterprise Zones
Office of Business and Education Coordination
Office of Film and Television Services
Office of the Michigan Business Ombudsman
Office of the Small Business Clean Air Ombudsman
Personal Property Tax Exemption
Plant Rehabilitation and Industrial Development Districts
State Education Tax Exclusion
Travel Michigan
Wurtsmith Conversion Authority

Executive Order No. 1999-1 further authorized MSF to enter into an interlocal agreement with local public agencies. Under this authority, MSF created the Michigan Economic Development Corporation (MEDC) as a new public entity to help administer programs transferred to MSF. Any economic development programs transferred to MSF could be transferred, along with the relevant personnel and funding, to the new MEDC. MSF entered into an interlocal agreement with the Economic Development Corporation of the Charter County of Wayne, and MEDC was formed.

MSF is a component unit of the financial reporting entity of the State of Michigan. The decision to include a potential component unit in the reporting entity is made by applying the criteria set forth in Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*. The basic criteria include the appointment of a voting majority of the governing board of MSF; the legal separation of the State and MSF; the fiscal independence of MSF; whether exclusion of the unit would make the *State of Michigan Comprehensive Annual Financial Report* misleading; and whether there is a potential for MSF to provide specific financial benefits to, or impose specific financial burdens on, the State.

b. Basis of Presentation

Under fund accounting, the accounts of the component units of the State of Michigan are organized on the basis of funds, each of which is considered a separate accounting entity. MSF's operations are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenues, and expenditures. Government resources are allocated to and accounted for in separate funds, based upon the purposes for which they are to be spent and the means by which spending activities are controlled.

MSF is accounted for as a governmental fund. The accompanying financial statements present only MSF and are not intended to present fairly the financial position and results of operations of the State of Michigan or its component units.

c. Measurement Focus and Basis of Accounting

The term "measurement focus" refers to what is being measured, and the term "basis of accounting" refers to when revenues and expenditures are recognized in the accounts and reported in the financial statements. The basis of accounting relates to the timing of the measurement made, regardless of the measurement focus applied.

Governmental fund types are accounted for using the modified accrual basis of accounting. The modified accrual basis emphasizes the measurement of current financial resources and obligations. Revenues are recorded when they are measurable and available to finance expenditures of the current period. Revenues are considered to be available when collected within the current period or soon enough thereafter to pay liabilities of the current period. Generally, this is within 12 months. Expenditures are recorded at the time that fund liabilities are incurred.

New accounting standards were adopted in fiscal year 2000-01. MSF adopted GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, as amended by Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain*

Financial Statement Note Disclosures. Statement No. 34, as amended and modified, commonly referred to as the new reporting model, retained much of the old reporting and disclosure requirements under the prior reporting model, with certain modifications and newly added information. The most significant effect on MSF's financial statements was the reclassification of operating transfers to operating revenues and the addition of the management's discussion and analysis as required supplementary information. GASB Statement No. 34 requires that special purpose governments provide both fund financial statements and government-wide financial statements. GASB Statement No. 34 also provides for combining these statements using a format that reconciles the individual line items of the fund level (modified accrual) to the government-wide level (full accrual). Because this entity does not have any reconciling items (such as long-term debt and capital assets), the statements are presented using one column with combined titles.

d. Financial Data

The MSF Board of Directors entered into an interlocal agreement with a local unit of government to create MEDC. MEDC came into existence on April 5, 1999. In accordance with the terms of the agreement, substantial assets, liabilities, and fund balances of MSF were transferred to MEDC on May 1, 1999. All revenues received from tribal gaming, industrial development revenue bond (IDRB) issuance fees, and other sources are transferred to MEDC on a monthly basis. This interlocal agreement also detailed all of MSF's State classified employees to MEDC. State appropriations available to MSF for this purpose are also made available to MEDC, as needed.

MSF financial statements primarily present the following:

- (1) Revenues: Amounts received from tribal gaming revenue, CDBG from the U.S. Department of Housing and Urban Development, Employment Services grant from the U.S. Department of Labor, and other restricted revenues. Also included in revenues are the amounts available to MSF from State appropriations for fiscal years 2001-02 and 2000-01.

(2) Expenditures: CDBG pass-through grants and other minor administrative expenditures. Expenditures for the Employment Service grant from the U.S. Department of Labor were recorded in MEDC. Also included in expenditures are the tribal gaming revenue, IDRB issuance fees, and State appropriations collected by or appropriated to MSF and transferred to MEDC during fiscal years 2001-02 and 2000-01.

e. Investments

All investments of MSF, along with liabilities, were transferred to MEDC during fiscal year 1998-99.

f. Compensated Absences

The accumulated compensated absences liability is recorded in MEDC.

Note 2 Deposits and Investments

a. Deposits

Deposits reflected in MSF's bank accounts (without recognition of outstanding checks or deposits in transit) at September 30, 2002 were \$87,087, which was covered by federal depository insurance and was classified in GASB credit risk category 1. As of September 30, 2001, the deposit amounts were \$60,250, which was covered by federal depository insurance.

b. Investments

No investment activities occurred during either fiscal year.

Note 3 Other Current Assets

MSF's other current assets totaled \$4,661,891 at September 30, 2002 (\$5,311,863 at September 30, 2001). These balances consisted of:

	As of September 30	
	2002	2001
Other Current Assets:		
Tribal gaming revenue	\$ 4,600,000	\$ 5,298,031
Miscellaneous	61,891	13,831
Total Other Current Assets	<u>\$ 4,661,891</u>	<u>\$ 5,311,863</u>

Note 4 Bond Programs

MSF and a predecessor entity (the Michigan Job Development Authority) issued IDRBs. In addition, MSF issued bonds under its Taxable Bond Program. The bonds issued are payable solely from the net revenues of the project and are not an obligation of MSF or the State of Michigan. After the bonds are issued, all financial activities are assumed by a trustee, depository, or paying agent. Accordingly, these obligations are not reported in the MSF financial statements. Information regarding the status of such bond issues, including possible default, must be obtained from the trustee or depository for bonds, the industrial or commercial enterprise benefited by the bonds, or some other knowledgeable source.

The total amount of IDRBs issued by MSF and its predecessor entity for the period January 1, 1979 through September 30, 2002 was \$5,893,793,339 (\$5,771,118,339 through September 30, 2001). The total amount of bonds issued by MSF under the Taxable Bond Program for the period October 1, 2001 through September 30, 2002 was \$14,210,000 (\$8,290,000 during the previous fiscal year).

Note 5 Commitments and Contingencies

Taxpayers of Michigan Against Casinos, et al. v State of Michigan

In January 2000, an Ingham County circuit judge issued a declaratory ruling that the four new compacts were adopted in an unconstitutional manner. The State has appealed that ruling. It is not anticipated that this ruling will have an immediate effect on payments from the tribes because the compacts remain in effect until a federal court rules that they are void. It is not anticipated that

federal authorities would or could pursue such a ruling until after State appeals are exhausted.

Note 6 Major Revenue Sources

The implementation of GASB Statement No. 34 requires that amounts received from State appropriations be treated as direct revenue. MSF recorded \$60,002,770 (\$65,316,338 in fiscal year 2000-01) and \$45,000,000 (\$50,000,000 in fiscal year 2000-01) received from the State General Fund and Tobacco Settlement Trust Fund appropriations, respectively, as revenues in fiscal year 2001-02.

MSF recorded \$35,096,243 (\$40,424,671 in fiscal year 2000-01) in revenue and \$35,645,228 (\$40,663,095 in fiscal year 2000-01) in expenditures during fiscal year 2001-02 for the CDBG Program. This amount represented approximately 74.4% (71.8% for the fiscal year ended September 30, 2001) of total revenues (excluding funding from State appropriations) for the fiscal year ended September 30, 2002.

Another major revenue source for MSF is its 8% share of the net revenues derived from the class III electronic games of chance of several casinos located throughout Michigan. During the fiscal year ended September 30, 2002, revenue was recognized from this source in the amount of \$10,004,898 (\$9,294,225 during the previous fiscal year). This amount represented approximately 21.2% (16.5% for the fiscal year ended September 30, 2001) of total revenues (excluding funding from State appropriations) for the fiscal year ended September 30, 2002.

The opening of new tribal casinos and the licensure of casinos in Detroit pursuant to an initiative approved by Michigan voters in 1996 ended the obligation of seven tribes to make payments to MSF. Under a federal court agreement with the State, five tribes ceased making payments in June 1999. Two casinos stopped remitting required payments after February 19, 1999. In November 2001, the U.S. Court of Appeals for the Sixth Circuit upheld the judgment from a lower court releasing all seven tribes from their obligation under the 1993 compact to make payments to MSF. No further appeal is planned.

New compacts with four additional tribes were approved by a legislative resolution in December 1998. During fiscal year 2000-01, two of these four casinos contributed revenue to MSF. It is anticipated that revenue received from these four casinos will replace revenue lost from the earlier compact with seven tribes, to some extent, and will enable MSF/MEDC to continue to pursue its intended mission of aiding economic development in Michigan.

SUPPLEMENTAL FINANCIAL SCHEDULE

MICHIGAN STRATEGIC FUND
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2000 Through September 30, 2002

			For the Fiscal Year Ended September 30, 2001		
Federal Agency/Program	CFDA (2) Program Number	Pass-Through Identification Number	Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
<u>U.S. Department of Housing and Urban Development</u>					
Direct Program:					
Community Development Block Grants/State's Program (3), (4), and (5)	14.228		\$ 1,354,125	\$ 38,754,907	\$ 40,109,032
Total U.S. Department of Housing and Urban Development			\$ 1,354,125	\$ 38,754,907	\$ 40,109,032
<u>U.S. Department of Labor</u>					
Pass-Through Program:					
Michigan Department of Career Development					
Employment Service	17.207	205-Y01	\$	\$ 770,000	\$ 770,000
Total U.S. Department of Labor			\$ 0	\$ 770,000	\$ 770,000
Total Expenditures of Federal Awards			\$ 1,354,125	\$ 39,524,907	\$ 40,879,032

(1) Basis of Presentation: This schedule includes the federal grant activity of the Michigan Strategic Fund and is presented on the modified accrual basis of accounting. This information is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts may differ from amounts presented in, or used in the preparation of, the financial statements.

(2) CFDA is defined as *Catalog of Federal Domestic Assistance*.

(3) Program income increases the federal award; federal regulations allow for the entity to retain and spend program income according to the federal guidelines.

(4) CFDA 14.228 was transferred from the Michigan Jobs Commission as of April 1, 1999.

(5) CFDA 14.228 has open grants from program years 1997 through 2002.

For the Fiscal Year Ended September 30, 2002			
Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 2,385,321	\$ 32,428,127	\$ 34,813,448	\$ 74,922,479
\$ 2,385,321	\$ 32,428,127	\$ 34,813,448	\$ 74,922,479
\$	\$ 764,519	\$ 764,519	\$ 1,534,519
\$ 0	\$ 764,519	\$ 764,519	\$ 1,534,519
<u>\$ 2,385,321</u>	<u>\$ 33,192,646</u>	<u>\$ 35,577,967</u>	<u>\$ 76,456,998</u>



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting

December 27, 2002

Mr. Doug Rothwell, President
Michigan Strategic Fund
300 North Washington Square
Lansing, Michigan

Dear Mr. Rothwell:

We have audited the financial statements of the Michigan Strategic Fund, a component unit of the State of Michigan, as of and for the fiscal years ended September 30, 2002 and September 30, 2001, as identified in the table of contents, and have issued our report thereon dated December 27, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Michigan Strategic Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Michigan Strategic Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of

the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Michigan Strategic Fund's Board of Directors and management, the Legislature, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

A handwritten signature in black ink, reading "Thomas H. McTavish". The signature is fluid and cursive, with a long horizontal line extending from the start of the name.

Thomas H. McTavish, C.P.A.
Auditor General



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Compliance With
Requirements Applicable to Each Major Program
and on Internal Control Over Compliance in
Accordance With OMB Circular A-133

December 27, 2002

Mr. Doug Rothwell, President
Michigan Strategic Fund
300 North Washington Square
Lansing, Michigan

Dear Mr. Rothwell:

Compliance

We have audited the compliance of the Michigan Strategic Fund, a component unit of the State of Michigan, with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to each major federal program for the two-year period ended September 30, 2002. The Michigan Strategic Fund's major federal program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of the Michigan Strategic Fund's management. Our responsibility is to express an opinion on the Michigan Strategic Fund's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to in the previous paragraph that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Michigan Strategic Fund's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a

reasonable basis for our opinion. Our audit does not provide a legal determination of the Michigan Strategic Fund's compliance with those requirements.

In our opinion, the Michigan Strategic Fund complied, in all material respects, with the requirements referred to in the second previous paragraph that are applicable to each major federal program for the two-year period ended September 30, 2002. However, the results of our auditing procedures disclosed an instance of noncompliance with those requirements, which is required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying schedule of findings and questioned costs as Finding 1.

Internal Control Over Compliance

The management of the Michigan Strategic Fund is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Michigan Strategic Fund's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

We noted a matter involving internal control over compliance and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over compliance that, in our judgment, could adversely affect the Michigan Strategic Fund's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. The reportable condition is described in the accompanying schedule of findings and questioned costs as Finding 1.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control over compliance would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition identified in the previous paragraph is not a material weakness.

This report is intended solely for the information and use of the Michigan Strategic Fund's Board of Directors and management, the Legislature, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone

other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

A handwritten signature in black ink, reading "Thomas H. McTavish". The signature is fluid and cursive, with a long horizontal line extending from the start of the name.

Thomas H. McTavish, C.P.A.
Auditor General

SCHEDULE OF FINDINGS AND QUESTIONED COSTS*

Section I: Summary of Auditor's Results

Financial Statements

Type of auditor's report issued:	Unqualified*
Internal control* over financial reporting:	
Material weaknesses* identified?	No
Reportable conditions* identified that are not considered to be material weaknesses?	None reported
Noncompliance material to financial statements?	No

Federal Awards

Internal control over major programs:	
Material weaknesses identified?	No
Reportable condition identified that is not considered to be a material weakness?	Yes
Type of auditor's report issued on compliance for major programs:	Unqualified
Any audit findings disclosed that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133, Section 510(a)?	Yes

* See glossary at end of report for definition.

Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program</u>
14.228	Community Development Block Grants/State's Program

Dollar threshold used to distinguish between type A and type B programs: \$2,293,710

Auditee qualified as a low-risk auditee*? No

Section II: Findings Related to the Financial Statements

We did not report any findings related to the financial statements.

The status of the finding related to the financial statements that was reported in the prior Single Audit is disclosed in the summary schedule of prior audit findings.

* See glossary at end of report for definition.

Section III: Findings and Questioned Costs Related to Federal Awards

FINDING (07S0301)

1. Payroll Distributions

U.S. Department of Housing and Urban Development	CFDA: 14.228 - Community Development Block Grants/State's Program
Award Number: B-00-DC-26-0001 B-99-DC-26-0001 B-98-DC-26-0001 B-97-DC-26-0001	Award Period: 01/01/00 - Depletion 01/01/99 - Depletion 01/01/98 - Depletion 01/01/97 - Depletion
	Questioned Costs: \$262,637 \$144,916 \$114,342 \$ 7,601

The Michigan Strategic Fund (MSF) did not establish controls to ensure compliance with federal requirements related to payroll charged to the Community Development Block Grants (CDBG) Program.

OMB Circular A-87, Attachment B, requires that appropriate time distribution records support employee salaries and wages chargeable to more than one program. OMB Circular A-87, Attachment B, 11.h, states that distribution percentages determined before the services are performed do not qualify as support for charges to a federal award. However, substitute systems for allocating salaries and wages to federal awards may be used in place of activity reports. These systems are subject to approval by the cognizant agency.

The total federal payroll costs charged by MSF for both fiscal years was \$1,466,782. The Michigan Business Development Account Managers and the CDBG Program staff primarily charge payroll costs to the CDBG Program. The CDBG Program payroll costs were appropriately charged to the CDBG Program. However, MSF's allocation of the payroll costs for the Michigan Business Development account managers was based on a composite of several factors. These factors included the geographic area the individual was assigned to and the extent that the government jurisdictions were eligible for CDBG funding. The

proportion of the activities of the individual account managers charged to the CDBG Program is based on the distribution of population between eligible and noneligible jurisdictions. MSF staff felt that the distribution of the population is generally considered to be reflective of the distribution of business facilities. This practice is considered a substitute system for allocating salaries, which would require approval by the cognizant agency. MSF did not have any approval. Furthermore, MSF's substitute system is also based on the premise that 100% of the account managers' activities are eligible for CDBG reimbursement.

MSF has provided additional information to the cognizant agency and is still awaiting approval for the substitute system. Because the cognizant agency has not yet made a determination, we have included all payroll costs related to the account managers for fiscal years 2001-02 and 2000-01 as questioned costs (\$529,496).

RECOMMENDATION

We recommend that the MSF establish controls to ensure compliance with federal requirements related to payroll charged to the CDBG Program.

The status of the findings related to federal awards that were reported in the prior Single Audit is disclosed in the summary schedule of prior audit findings.

OTHER SCHEDULES

MICHIGAN STRATEGIC FUND
Summary Schedule of Prior Audit Findings
As of September 30, 2002

PRIOR AUDIT FINDINGS RELATED TO THE FINANCIAL STATEMENTS

Audit Findings That Have Been Fully Corrected:

Audit Period: October 1, 1998 through September 30, 2000
Finding Number: 07S0101
Finding Title: Accounts Payable Estimation
Finding: The Michigan Strategic Fund (MSF) had not developed procedures to ensure the proper recording of fiscal year-end accounts payable for the Community Development Block Grants (CDBG) Program.
Status: MSF has developed procedures to better ensure the proper recording of fiscal year-end accounts payable for the CDBG Program.

PRIOR AUDIT FINDINGS RELATED TO FEDERAL AWARDS

Audit Findings That Have Been Fully Corrected:

Audit Period: October 1, 1998 through September 30, 2000
Finding Number: 07S0102
Finding Title: Subrecipient Monitoring
Finding: MSF had not established a comprehensive subrecipient monitoring process to ensure that CDBG awards provided to subrecipients were expended in accordance with applicable laws, regulations, and provisions of contracts or grants.
Status: MSF has established a subrecipient monitoring process to ensure that CDBG awards provided to subrecipients are expended in accordance with applicable laws, regulations, and provisions of contracts or grants.

Audit Period: October 1, 1998 through September 30, 2000
Finding Number: 07S0103
Finding Title: Accounts Payable Estimation
Status: See Finding 07S0101 with the findings related to the financial statements.

MICHIGAN STRATEGIC FUND

Corrective Action Plan

As of June 13, 2003

FINDINGS RELATED TO THE FINANCIAL STATEMENTS

There were no findings related to the financial statements for fiscal years 2000-01 and 2001-02.

FINDINGS RELATED TO THE FEDERAL AWARDS

Finding Number:	07S0301
Finding Title:	Payroll Distributions
Management Views:	The Michigan Strategic Fund (MSF) disagrees with the finding and questioned costs.
Corrective Action:	MSF obtained approval from the U.S. Department of Housing and Urban Development (HUD) on March 6, 2003 for its substitute system for allocating payroll costs for account managers whose area of responsibility covers nonentitlement counties that contain entitlement communities. MSF has provided additional information and has requested that HUD review whether 100% of the account managers' activities are eligible for reimbursement under CDBG. Once HUD makes a determination as to the allowability of the account managers' activities, MSF will implement any necessary adjustments in its payroll allocation methodology.
Anticipated Completion Date:	September 30, 2003.
Responsible Individual:	Thomas Freeman, Managing Director CDBG

Glossary of Acronyms and Terms

CDBG	Community Development Block Grants.
CFDA	<i>Catalog of Federal Domestic Assistance.</i>
detailed employees	The temporary assignment of employees from a governmental entity to another business entity. Employees in this capacity continue to receive the same compensation and benefits of the original employer, but receive day-to-day direction (work assignments and supervision) from the entity they are detailed to.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are fairly presented in conformity with the disclosed basis of accounting.
GASB	Governmental Accounting Standards Board.
HUD	U.S. Department of Housing and Urban Development.
IDRB	industrial development revenue bond.
internal control	A process, effected by management, designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
low-risk auditee	As provided for in OMB Circular A-133, an auditee that may qualify for reduced federal audit coverage if it receives an annual Single Audit and it meets other criteria related to prior audit results. In accordance with State statute, this Single Audit was conducted on a biennial basis; consequently, this auditee is not considered a low-risk auditee.

material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the results of operations or cash flows in conformity with the disclosed basis of accounting.
material weakness	A reportable condition related to the design or operation of internal control that does not reduce to a relatively low level the risk that either misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and/or financial statements or noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
MEDC	Michigan Economic Development Corporation.
MSF	Michigan Strategic Fund.
OMB	U.S. Office of Management and Budget.
questioned cost	A cost that is questioned by the auditor because of an audit finding: (1) which resulted from a violation or possible violation of provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds; (2) where the costs, at the time of the audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.
reportable condition	A matter coming to the auditor's attention relating to a significant deficiency in the design or operation of internal control that, in the auditor's judgment, could adversely affect

the entity's ability to (1) record, process, summarize, and report financial data consistent with the assertions of management in the financial schedules and/or financial statements or (2) administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.

Single Audit

A financial audit, performed in accordance with the Single Audit Act Amendments of 1996, that is designed to meet the needs of all federal grantor agencies and other financial report users. In addition to performing the audit in accordance with the requirements of auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, a Single Audit requires the assessment of compliance with requirements that could have a direct and material effect on a major federal program and the consideration of internal control over compliance in accordance with OMB Circular A-133.

unqualified opinion

An auditor's opinion in which the auditor states that:

- a. The financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting; or
- b. The financial schedules and/or financial statements presenting supplemental financial information are fairly stated in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did

not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules taken by themselves; or

- c. The audited agency complied, in all material respects, with the cited requirements that are applicable to each major federal program.